

Report to the United States Senate
Permanent Subcommittee on Investigations

Day Trading Practices
In
Washington State

September - November 1999

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REPORT TO THE UNITED STATES SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

EXECUTIVE SUMMARY

In September 1999 the examination section of the Washington State Securities Division¹ undertook the task of conducting field examinations of all day trading firms with branches in the State of Washington². The examinations focused on gathering information regarding alleged predatory practices by day trading firms.

From September through November 1999, the Securities Division examined seven day trading firms doing business in the State of Washington. Three areas of regulatory concern arose from the examination of these firms: (1) Extensive Customer Losses (2) Unregistered Broker-Dealer and Investment Adviser Activity and (3) Questionable Loans to Customers.

Customer Losses: Information gathered from the exams indicates that the majority of customers (77%) who participated in day trading at these firms lost money. Customers lost an average of \$36,000, with some customer losses reaching over \$600,000.

Unregistered Activity: The Securities Division found that one firm appeared to be engaging in broker-dealer activity without being registered. The Securities Division also found certain persons trading accounts for other customers were not registered as investment advisers.

Questionable Loan Activity: The Securities Division found questionable loan activity at three firms. These loans appeared to be attempts to circumvent margin limits.

Enforcement Actions: Specific findings regarding questionable lending, unregistered broker-dealers and investment advisers have been referred to the Securities Division's Enforcement Division for further investigation and possible regulatory action.

¹ The Securities Division is a Division of the Department of Financial Institutions. The Division of Securities was established in the early 1930's and now administers the Securities Act, Franchise Investment Protection Act, Business Opportunity Fraud Act, and Commodities Act. The primary mission of the Division of Securities is to protect Washington State residents from the dishonest or fraudulent practices of people offering and selling securities and investment advice. The Division accomplishes this mission through a variety of regulatory and enforcement tools, including registration and examination requirements of broker-dealers and investment advisers.

² The firms reviewed were Action II, All-Tech Investment Group Inc., Bright Trading, Cornerstone Securities Corporation, Day Trade Technologies, On-Line Investment Services, and Richmark Capital Corporation.

THE PROJECT

The examination team was assigned the responsibility of inspecting the activities of day trading firms for sales practice violations, questionable loans or guarantees, third-party trading and unsuitable trading accounts. The team was also given the task of looking into possible unregistered broker-dealer and investment adviser activities, short sale violations, and any evidence of misleading advertising.

Assignments and Choice of Firms:

A review of our registration records and advertising indicated there were seven day trading firms with branches located in the State of Washington. All examined day trading firms were located in or near the Seattle metropolitan area. The firms were divided among three members of the examination team; a Securities Division enforcement attorney was assigned to oversee the legal aspects of the assignment. Those members representing the audit team were Mr. Gene Nakano, Mr. Gary Smith, and Ms. Joanne Jones. Ms. Kristina Kneip represented the enforcement staff. These examinations were conducted during the months of September, October and November, 1999. Certain facets of those examinations have been referred to Enforcement for further investigation and possible regulatory action.

Project Findings:

Of the seven day trading firms examined by the audit team, two firms accounted for more than 80 percent of the 585³ day trading accounts serviced by the firms. In part, the reason for their dominance in the area is that they have been in the community longer than the other day trading firms.

Types of Customer and Accounts: Of the 585 customer accounts serviced by day trading firms in the Puget Sound Region, 481 are actively traded⁴; the remainder are either closed or maintain long-term investment positions. Four of the seven firms examined cater only to day trading customers. Three of the firms have some accounts held by longer-term investors.

Off-site Trading: Three of the seven firms examined provided their customers with the opportunity to trade at an “off site” location as well as at a trading room location supervised by the firm. One firm provided only “off-site” trading. Three hundred and sixty customers took advantage of “off-site” trading.⁵ Customers trading “off-site” were found to be as active as on site traders.

³ See Exhibit “A”.

⁴ See Exhibit “A”.

⁵ See Exhibit “A”.

Accounts Reviewed:

Monthly statements for 124 open and active day trading accounts were reviewed and analyzed as part of the examination process. The analysis shows the net profits and losses for those accounts, the time period the accounts were open and the beginning balances for the accounts.

Net Profits and Losses: Of the accounts examined, 96 (or 77%) were found to have net losses.⁶ Of these accounts, 9 had losses over \$100,000.⁷ The highest loss discovered was \$641,000.⁸ The average net loss in these accounts was calculated to be \$36,043.⁹

Of the accounts examined, 28 (or 23%) were calculated to have net profits.¹⁰ Only two accounts were found to have gains of over \$100,000.¹¹ The highest profit discovered was \$160,100.¹² The average net profit in these accounts was calculated to be \$21,983.¹³

Time Period: Accounts reviewed ranged from those open for one month to accounts traded for as long as 25 months.¹⁴ Some closed accounts were also reviewed, but these accounts remained open for short periods of time. After having suffered trading losses, many accounts were closed within six months after they were initially opened. The length of time an account was open and active did not appear to have a correlation with the success of the account.

Beginning Account Balances: Most of the firms examined claimed to have a \$20,000 minimum opening account balance threshold. Examination of customers monthly statements showed that opening balances for accounts ranged from as little as \$6,000 to as much as \$1,800,000.¹⁵ These opening balances were composed of both cash and securities. In accounts where the opening balance was over \$100,000 the deposit was generally made up of securities from another broker-dealer.

Questionable Activity:

Loans to Customers: Activity involving loans to customers was examined at each firm.¹⁶ The most common type of loan situation found involved the firms facilitating loans between customers through journal entry notations. This was revealed to

⁶ See Exhibit "B".

⁷ See Exhibit "C".

⁸ See Exhibit "D", page 1.

⁹ See Exhibit "B".

¹⁰ See Exhibit "B".

¹¹ See Exhibit "C".

¹² See Exhibit "D", page 3.

¹³ See Exhibit "B".

¹⁴ See Exhibit "C".

¹⁵ See Exhibit "C".

¹⁶ See Exhibit "A".

be a common practice at two of the firms examined. The loan authorization forms used at the firms appeared to be pre-signed photocopies, indicating that the firms were assisting the customers in finding the lender. Funds being journaled between accounts within the firm raise questions regarding proper internal controls and whether authorization was received prior to the funds being transferred.

A second questionable loan practice was discovered at a firm that was unregistered. The firm facilitated loans to its customers, on a regular basis, through a company solely owned by the firm's principal. The purpose of the separate company appears to be a way to get around compliance with Regulation T.

A third type of situation was found where the company operating the day trading firm obtained a loan from a customer. The practice of a broker-dealer obtaining a loan from a customer is prohibited as an unethical practice. The Securities Division is looking into whether loans by affiliates to customers of the day trading firm are an unethical practice.

Unregistered Investment Advisory Activity: Our review of trading activity, account information and correspondence revealed that one firm had customers or employees engaging in third party trading.¹⁷ Though the customers signed discretionary trading forms allowing these individuals to "trade" for them, the individuals who were given this authorization were not registered as Investment Advisers. As such they violate Investment Advisory regulations and these activities clearly point to a paucity of on-site supervision by the firm. The on-site principal clearly lacked the capacity to understand the gravity and the consequences that unregistered Investment Adviser activity has on the firm, and the clients and employees who engage in it. Two accounts where third-party trading has taken place have been referred to Enforcement for further investigation regarding investment adviser registration violations.

Suitability: The review of opening balances did raise suitability concerns. Each of the firms had established a policy regarding the minimum balance required to open a day trading account. In some instances the branch manager or the compliance officer approved new accounts with opening balances substantially under the minimum, rather than holding firm's pre-determined minimum account balance. These practices raise the question as to whether the firms are violating suitability review requirements, as required under NASD Rule 3010 and NASD Rule 2310.

Other Findings:

Advertising: The examination teams examined the advertising of day trading firms. The firms reviewed were running few advertisements during the examination period, and two of the firms were not engaging in any advertising at all. While no misleading claims of performance or success were discovered during the time period of

¹⁷ See Exhibit "A".

the initial examinations,¹⁸ questionable advertising recently appeared on the web site of one of the firms examined. The advertising touted the success of a principal of the firm, without providing a disclaimer, in violation of SEC Rule 270.34b-1 and NASD Rule 2210. Affirmative disclaimers are required due to the high risk of the activity. The offending advertisement has been referred to Enforcement for further action.

Short Sales: Firms were examined for compliance with the short sale rules. Rules promulgated by the Securities and Exchange Commission and the National Association of Securities Dealers prohibit making a short sale on a downtick in price. Each firm that operated a trading room was examined to ensure that it had procedures to detect short sale violations. The examination team did not detect any violations of this rule.

Background for the Project:

Sampling Techniques: Of the five smaller firms examined, almost all accounts were reviewed. For the two firms that did the bulk of day trading business, the audit team randomly sampled certain actively traded accounts by pulling every tenth account. The emphasis was on examining between 10-15 percent of the actively traded accounts. Some of the active accounts that had been closed were also examined on a random basis. There was no discernable difference between active or closed accounts in the amount of losses or in the opening account balances each account brought to the day trading firm when they started their day trading activity.

Conclusions:

Over the three-month period of September, October and November 1999, seven day trading firms and 124 customer accounts were analyzed by members of the Securities Division's Examination Team. More than three-quarters of the customers at these firms lost money. Lending practices facilitated by the firms may have exacerbated those customer losses. These lending practices appear to have allowed customers to obtain loans in excess of the amounts available to them under normal trading conditions.

The examinations also revealed that some firms were offering day trading services without being registered. A review of activities at the day trading firms also revealed that customers and employees at the firms may be giving investment advice to other customers without being registered. Such unregistered activities heighten the risks of customers trading through those firms, since the safeguards and disclosure required under the regulatory rubric are missing.

¹⁸ The examinations in Washington State occurred during a time when advertising across the day trading industry waned following scrutiny by the NASD and the State of Massachusetts.